Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
AT&T Corp.	)	
Petition for Rulemaking To Reform Regulation Of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services	)	RM No. 10593

REPLY COMMENTS OF AT&T CORP.

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Pursuant to the Commission's *Notice* in this proceeding,[1] AT&T submits these reply comments in support of its Petition requesting that the Commission promptly initiate a rulemaking to reform regulation of price cap incumbent local exchange carrier ("ILEC") rates for interstate special access services.

INTRODUCTION AND SUMMARY

If the Bell Operating Companies are to be believed, special access markets are the most peculiar of markets. As these markets become fiercely competitive, the incumbent providers' prices rise, even as their costs rapidly decline. Competition brings the incumbents higher profits and no pressure to match competitors' offers. Customers with real alternatives not only line up to pay the incumbents more, but merrily sign away all future rights to buy from others. In other

[1] *See* Public Notice, DA 02-2913 (released October 29, 2002); *see also* Public Notice, DA 02-3393 (released December 9, 2002) (granting extension of time for reply comments).

words, these are markets in which competitors are not merely to be tolerated, but affirmatively recruited.

In the real world, however, up is not down, and smoke does mean fire. The inconvenient fact that special access markets exhibit *all* of the recognized hallmarks of unconstrained market power cannot therefore, as the Bells urge, be dismissed as coincidence. And no amount of Bell table pounding that we are awash in competitive carriers and fiber can change the unfortunate reality that actual marketplace conditions are quite different from the Bells' representations and, more importantly, from the marketplace conditions that the Bells predicted and the Commission endorsed as the foundation for special access rate deregulation.

In 1999, the Commission endorsed the prediction that a Bell's satisfaction in an MSA of the collocation-based triggers for complete Phase II relief from price cap regulation would signal that "*almost all* special access customers" in that MSA "have a competitive alternative."[2] Today, we know better: purchasers of special access services have facilities-based alternatives to fewer than *one in ten* buildings, even in MSAs in which Phase II deregulation was granted nearly two years ago. And special access purchasers almost *never* have alternatives to the DS-1 circuits that account for the bulk of the Bells' special access revenues. The Commission expected that competing special access providers would continue to rely upon the Bells' facilities only "on a transitional basis" while each such carrier raced "to extend its own facilities to reach its customers."[3] But the bubble that provoked such optimism has burst, and it is now clear that competitors are *not* extending their own facilities to the vast majority of buildings, and cannot

[2] *Access Charge Reform, et al.*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd. 14221, ¶ 142 (1999) ("*Pricing Flexibility Order*") (emphasis added).

[3] *Id.* ¶ 158.

economically do so, particularly with respect to the critically important DS-level channel termination facilities between customers' premises and Bell central offices.

As the Bells' own economists recognize, "[w]hat matters for CLECs and IXCs is that they have economically realistic alternatives to RBOC special access facilities,"[4] and there is now overwhelming evidence that the hoped-for alternatives that were the underpinning for special access rate deregulation simply have not materialized. The Bells stir up a great deal of dust in their comments and unsworn special access "fact" report, but the highly aggregated national revenues, "fiber-miles" and other figures that they throw around are both entirely irrelevant to the local market power questions at hand, and, as demonstrated below and in the attached declarations, shockingly inaccurate. Although the Bells obviously know where they face competition and where they do not, they offer *no* data to rebut their special access customers' detailed showings that, with relatively few exceptions (and most of those among the small minority of buildings that can support OC-level optical fiber facilities), the facilities-based alternatives that the Commission expected and relied upon simply do not exist.

The Bells do offer plenty of contrary rhetoric, but it founders on their own well-documented behavior. Special access rate deregulation was justified on the need to reduce prices to meet competition and the promise that rate deregulation would produce lower rates for special access customers. The theory was that competitive pressure would force the Bells to meet competitors' prices and other terms and to negotiate contracts tailored to customers' individual needs.[5] But the Bells' real world practices confirm that, whatever the Commission might

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[4] Kahn/Taylor Decl. at 20.

[5] *MCI WorldCom, Inc.* v. *FCC*, Nos. 99-1395, Brief of Respondents FCC, at 17 (filed July 2000) ("The Commission established predictive rules," determining "that collocation could serve as a proxy for measuring competitive pressure on the ILEC").

reasonably have anticipated in 1999, the Bells, in fact, feel no such competitive pressures. No Bell has reduced any special access rate to meet competition on any point-to-point route, notwithstanding that CLECs are offering very substantial discounts off the corresponding Bell rates on the small minority of routes where CLECs have bypassed the Bells' facilities. On the few DS-level routes where there is real competition among multiple facilities-based entrants, for example, competing carriers' rates are often *less than half* the corresponding Bell rates. Rather than meet the competition on these routes, however, the Bells have simply ceded them and maintained or raised their already supracompetitive rates throughout the MSA. The monopoly profits on the vast majority of routes where the Bells' face no competition more than make up for business lost by failing to meet competition where it exists (and the Bells can even hold their own even on competitive routes through anticompetitive optional pricing plan terms that lock out competitors and through price discrimination implemented through changes to rate *structure*).

Verizon, BellSouth and Qwest have raised DS-level rates in *every* single one of their Phase II MSAs. These rate increases are far too large and one-sided to chalk up to "rate rebalancing" – the Bells have increased DS-level channel termination rates as much as *70%*. And, as IXC, CLEC, wireless, and broadband special access customers have all documented, the Bells refuse even to engage in serious negotiations over their special access rates. These are damning facts that can only be explained by the abuse of enduring market power.

Recognizing as much, the Bells insist that their special access revenues have actually declined on a *per line* basis. Upon examination, however, the Bells' per line data only further confirm that their special access rates are patently unjust and unreasonable. The Bells use averages to conceal the fact that truly insignificant per line rate declines from 1997 to 2000 (some of which are largely attributable to X-Factor reductions and other *regulation* that pricing flexibility has allowed the Bells to escape) abruptly switched to per line rate *increases* in 2001. That, of course, is when the Commission began granting Phase II deregulation and the Bells responded with steep rate increases on the DS-level services for which they face no meaningful competition. More importantly, the same Bell data reveal enormous declines in the Bells' per line *costs* of providing special access – whether measured by expenses or investment, the per line costs the Bells reported in 2001 are barely *half* the levels reported in 1997. Thus, even if the Bells' false claims that their per line special access revenues are declining a percent or two a year could be credited, that could only confirm market power and unjust rates, given that costs are declining *10 to 20 times faster*.

But the evidence that the Bells are not experiencing the competitive pressures upon which rate deregulation was justified extends well beyond the Bells' unambiguously anticompetitive pricing behavior. The Bells also refuse to provide the same service quality guarantees that competing carriers routinely offer. And but for recent Commission intervention, the Bells would have succeeded in demanding literally hundreds of millions of dollars in bogus "security deposits" from captive special access customers. In rejecting these latter proposals, the Commission expressed "serious concerns" that they would be "used against customers in a discriminatory manner."[6] Those are, indeed, serious concerns, because the normal competitive market response of customers faced with such unreasonable demands – *i.e.*, to say "no thanks" and switch suppliers – is rarely available to special access purchasers.

And then there are the Bells' truly extraordinary special access profits. The Bells do not deny that sustained supracompetitive profits are a universally-accepted indicator of

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[6] *Verizon Petition for Emergency Declaratory and Other Relief*, WC Docket No. 02-202, Policy Statement, ¶ 14 (released December 23, 2002).

unconstrained market power or that the Commission and the courts have consistently ruled that rates that allow a Title II carrier to earn "creamy returns" are *necessarily* unjust and unreasonable. Instead, the Bells claim that the ARMIS-based returns that they resolutely defended as accurate measures of profitability when they supported rate *increases* (through "low-end" adjustments to price caps) have suddenly become meaningless now that they demonstrate the need for rate *decreases*. After complaining for years that historical ARMIS costs are the best measure of their actual costs of providing service, the Bells now contend (in this context only) that forward-looking economic cost-based measures of profitability are preferable. But that merely establishes that the Bells' enormously high ARMIS-based returns are *understated*, because returns based upon forward-looking costs are uniformly higher – even if the Bells' own inflated estimates of forward-looking costs are used. The Bells also suggest (but make no effort to demonstrate) that separation and allocation mismatches have made a hash of their category-specific ARMIS-based returns. In fact, as detailed below and in the attached declarations, none of the supposed errors the Bells identify has any material impact on the return calculations. This is not a close case upon which reasonable minds could differ. The Bells returns' are *many times* competitive market levels under any conceivable measure of costs, which explains why the Bells offer *no* competing return calculations.

In short, it is now all too clear that earlier predictions were wrong and that the existing market-based regulatory regime is not up to the task of ensuring that the Bells' special access rates are just and reasonable. It is equally clear that the Commission has a legal obligation promptly to remedy this problem.

The Bells suggest that the D.C. Circuit's decision affirming the 1999 *Pricing Flexibility Order* gives the Commission *carte blanche* to pretend that all is well. But, in a string of consistent decisions that the Bells refuse even to address, that court has repeatedly stressed that precisely the opposite is true. As the court has cautioned, "[t]he Commission's necessarily wide latitude to make policy based upon predictive judgments deriving from its general expertise implies a correlative *duty* to evaluate its policies over time to ascertain whether they work – that is, whether they actually produce the benefits the Commission originally predicted they would."[7] Thus, the Commission would be obligated to assess whether competitive pressures have proven an effective substitute for regulation even in the absence of AT&T's Petition. Now that the Commission has been presented with uncontraverted evidence that deregulation of the Bells' special access rates has not produced *any* of the predicted benefits and is, in fact, causing great harm to consumers and competition, the duty to act cannot conceivably be denied.

Indeed, the D.C. Circuit has specifically "emphasize[d] the need for the Commission to vigilantly monitor the consequences of its rate regulation rules" where, as here, "the Commission itself has recognized the tentative nature of its predictive judgments."[8] The predicted competitive pressures that were the only justification (and remain the only *possible* justification) for special access rate deregulation do not exist, and the Commission must initiate a rulemaking proceeding to determine what steps are necessary to remedy the problem. This is no longer a discretionary matter. As for the Bells' cries that they need their monopoly special access profits to finance unspecified "broadband" investments, it suffices to note that there is no "we have big plans for the money" exception to the requirement of just and reasonable rates.

Nor can there be any remaining doubt that this is a matter that warrants the Commission's immediate attention. There is no bigger scam being perpetrated under this Commission's watch

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[7] *Bechtel* v. *FCC*, 957 F.2d 873, 881 (D.C. Cir. 1992) (emphasis added).

[8] *ACLU* v. *FCC*, 823 F.2d 1554, 1565 (D.C. Cir. 1987).

– the Bells are stealing literally billions of dollars from their captive special access customers. Indeed, in just the 100 days since AT&T filed its Petition, the Bells have earned well over *one billion* dollars more than they would have earned if their returns were held to 11.25%. And the situation can only deteriorate as price cap regulation of the remaining MSAs is lifted and the Bells respond with additional rate increases. For a Commission that prides itself on enforcement, this unprecedented failure to enforce the Act's most basic requirement of just and reasonable rates should be intolerable.

Moreover, as the entire spectrum of carrier and end user customers of special access explain, the Bells' grossly excessive special access rates have extraordinarily far-reaching anticompetitive consequences. Special access is a critical input to *all* suppliers of wireless, broadband, and long distance services (and, because of the use and commingling restrictions, suppliers of local services as well). The Bells' inflated special access rates therefore not only increase the rates that end users must pay for all of these services, but give the Bells' wireless, broadband, and long distance affiliates an artificial competitive advantage. Swift action to constrain special access rates to just and reasonable levels will, accordingly, bring direct and very substantial benefits to consumers and competition in all communications markets.

Finally, because the need for rate reductions and reform is so clear and the harm caused by the existing rules (or lack thereof) so great, the Commission should also enter appropriate interim relief. The Commission should begin by repealing the rules of its own creation that prevent the competitive pressures upon which rate deregulation was based – *i.e.*, the anticompetitive use and commingling restrictions that prevent special access customers from substituting network elements for overpriced special access services.

The Commission should also provide interim relief with respect to the special access rates themselves. The Bells claim that the Commission is powerless to do so, but that is plainly wrong. There can be no serious legal objection to a moratorium on additional rate deregulation – an agency has great discretion to place interim "freezes" on its programs while "evaluat[ing] whether the programs actually [are] achieving – rather than frustrating – the[ir] purpose[s]."[9] Nor is there any Section 205 procedural bar to, as an interim measure, subjecting Phase II special access services to price cap regulation designed to produce more reasonable returns. It has been settled for more than a decade that changes to price cap rules are not rate prescriptions at all, because those rules only establish "safe harbors" of presumptively lawful rates,[10] and the notice and comment provided in the proceeding would, in any event, satisfy the Section 205 requirements. Moreover, labeling interim constraints on special access charges a "prescription" would necessarily be a "gross mischaracterization" so long as those charges were subject to adjustment following final Commission rate determinations.[11] The interim relief requested here also has the advantage of consistency with the reasoning that produced the *Pricing Flexibility Order*. There, the Commission expressly recognized that rate deregulation could be appropriate only in areas in which almost all special access customers have alternative suppliers. The requested interim rate relief will merely ensure that rates are constrained where such competitive pressures do not exist. Where competition is, in fact, driving prices down, the Bells will retain downward flexibility to respond and price caps should be no constraint at all.

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[9] *Western Coal Traffic League* v. *Surface Transportation Board*, 216 F.3d 1168, 1173-74 (D.C. Cir. 2000).

[10] *See*, *e.g.*, *Policy and Rules Concerning Rates for Dominant Carriers,* Report and Order, 4 FCC Rcd. 2873 ¶¶ 894-95 (1989).

[11] *Lincoln Tel. & Tel.* v. *FCC*, 659 F.2d 1092, 1107 (D.C. Cir. 1981).

I. BY ANY MEASURE, THE BELLS HAVE, AND ARE ABUSING, MARKET POWER OVER SPECIAL ACCESS SERVICES.

A. Special Access Purchasers Do Not Have The Competitive Alternatives Upon Which Market-Based "Regulation" Of The Bells' Special Access Rates Has Been Based.

Reliance upon market forces to constrain the Bells' special access rates can make sense only if those market forces actually exist – *i.e.*, only if real world purchasers of special access *can* turn to other suppliers if the Bells' demand supracompetitive rates. As Drs. Kahn and Taylor concede, "[w]hat matters for CLECs and IXCs is that they have economically realistic alternatives to RBOC special access facilities."[12]

And, as the Bells misleading submissions confirm, a fair amount of precision in defining relevant markets is important here. First of all, these are point-to-point markets[13] – the fact that a competing carrier has facilities to one building is no comfort to a special access purchaser seeking to serve a customer in another building.

Equally important, special access consists of three major components – entrance facilities, interoffice transport, and channel terminations – and the economics of building alternatives to these three components differ markedly. Most competitors' facilities are entrance facilities; competitors often do not have enough traffic to justify the much higher cost of building

[12] Kahn/Taylor Decl. at 20.

[13] The Commission has repeatedly recognized that markets for exchange access are "point-to-point markets" or markets of "discrete local areas." *See MCI-WorldCom Merger Order*, 13 FCC Rcd. 18025, ¶ 166 (1998); *LEC Regulatory Treatment Order*, 12 FCC Rcd. 15756, ¶ 67; *Bell Atlantic-NYNEX Merger Order*, 12 FCC Rcd. 19985, ¶¶ 54-56 (1997). Indeed, Dr. Taylor has in this very context acknowledged that "the services in question are point-to-point connections, and a point-to-point connection cannot be transported from other parts of the region." Affidavit of Karl McDermott and William E. Taylor, CC Docket No. 99-24, at 6-7 (filed Jan. 20, 1999). *See also* Ordover/Willig Reply Decl. ¶ 18.

interoffice transport, and competitors build channel termination facilities only to the very small subset of buildings that have enormous demand.[14] Because deployment of alternative channel terminations is almost never cost-justified, the fact that competitors may have deployed alternative transport (in a "fiber-based collocation") has no bearing on whether there is any competition for channel terminations or whether deregulation of channel termination rates is warranted. Moreover, as long as the Bell has a monopoly in one component – and the Bell almost always has a monopoly over at least the channel termination link – the Bell can extract monopoly profits in the absence of regulation.[15]

For similar reasons, the economics of serving higher capacity lines and lower capacity lines also differ markedly. Because competitors can economically build only to buildings with very high demand, most facilities-based alternatives are used to provide service at the OC level. Competitors are usually not in a position to provide a facilities-based alternative to the Bell for DS3 level services, and competitors almost never provide alternatives for customers served at the DS1 level. Thus, the fact that competing providers have made significant inroads in deploying the highest capacity OC-level transport facilities, for example, does not respond at all to the relevant showings that special access purchasers generally have *no* alternative suppliers for the bread and butter DS-level services they need to serve the vast majority of buildings that cannot support OC-level connections.

In both the *Pricing Flexibility Order* and prior orders relaxing special access rate regulation, the Commission assumed and predicted that alternative suppliers would be available across the board to those unhappy with the Bells' prices. For example, in the *Pricing Flexibility*

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[14] *E.g., Pricing Flexibility Order* ¶¶ 81, 102.

[15] Ordover/Willig Reply Decl. ¶ 22.

Order, the Commission explained that its collocation triggers were intended to "ensure that competitors have established significant market presence, *i.e.*, that competition for a particular service within the MSA is sufficient to preclude the incumbent from exploiting any monopoly power over a sustained period,"[16] which the Commission recognized would require that "*almost all* special access customers have a competitive alternative."[17]

The Commission recognized in 1999 that in the real world, special access purchasers often did not, in fact, have competitive alternatives for channel terminations, but predicted, based upon the prevalence of collocation, that that would change quickly: "Despite the shortcomings of using collocation to measure competition for channel terminations, moreover, it seems likely that a new market entrant would provide channel terminations through collocation and leased LEC facilities only on a transitional basis and will eventually extend its own facilities to reach its customers."[18]

It is now clear that this prediction has not and will not come true. Indeed, the commenters now essentially agree on the central point: CLECs have built their own facilities to only a very small fraction of the buildings served by special access. Verizon repeats its claim that CLECs serve 330,000 buildings, but it acknowledges that this estimate includes buildings served using *ILEC* facilities.[19] Verizon then states that "CLECs have estimated that the number of unique office buildings served entirely by their fiber networks (*i.e.*, 'on-net' buildings) is

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[16] *Pricing Flexibility Order* ¶ 141.

[17] *Id.* ¶ 142 (emphasis added).

[18] *Id.* ¶ 104.

[19] *See* Verizon, Attachment 1 at 13. The 330,000 figure is itself highly dubious. *See* Selwyn Decl. ¶ 46.

roughly 30,000 nationwide."[20] That is consistent with estimates given by other parties in this proceeding.[21] And it is also consistent with AT&T's demonstration that it is able to use either its own or a CLEC's facilities in only about *five percent* of the buildings in which it provides special access.[22] Given that 30,000 buildings represents a tiny fraction of the total number of commercial buildings in the United States,[23] the record unequivocally establishes that there are CLEC alternatives in only a tiny percentage of cases.

The Bells do not dispute this conclusion; rather, they argue that only a small number of buildings really matter for the special access purposes.[24] That is not the case. AT&T provides special access based service to 186,135 buildings nationwide, but it serves only 6,727 (or 3.6%) of those buildings with its own facilities, and those buildings account for only about 20% of its total DS1 equivalents.[25] In other words, even when AT&T's self-supply is included, AT&T still has no choice but to rely on the Bells for the vast majority of its *total* traffic.

More importantly, the DS1 equivalents that AT&T serves over its own or CLEC facilities are overwhelmingly concentrated in services provided at the OCn level. In the vast majority of buildings, however, AT&T provides only a DS0, DS1, or DS3 service – a level of traffic that would not economically justify deploying facilities. Although AT&T uses its own or a CLEC's

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[20] Verizon, Attachment 1 at 13.

[21] *See, e.g.*, Sprint at 4 (estimating that alternative vendors exist for 29,884 buildings nationwide, although the vendor can serve the entire building in only 17,000).

[22] AT&T Petition, Thomas Decl. ¶ 3; *see also* WorldCom at 8-9 (alternative available to only 11 percent of buildings served).

[23] *See* Selwyn ¶ 18.

[24] *See, e.g.*, Verizon, Attachment 1 at 13.

[25] *See* Selwyn Decl. ¶ 9 & Table 6. Since filing its Petition, AT&T has established a precise count of the buildings it serves through its own facilities, which are presented in the Selwyn (continued. . .)

facilities to offer a substantial percentage of its OCn services, AT&T relies upon the Bells for over 93% of its DS1 equivalents provided as DS1 services, and has no choice but to do so, because the vast majority of buildings served at the DS1 level are served *only* by the incumbents' facilities.

This is as true of Phase II pricing flexibility MSAs as it is of those that remain subject to price caps. Even in MSAs where the Bells have Phase II relief for both transport and channel terminations, AT&T has no competitive alternative in 93.8% of the locations it serves.[26] And even in the largest and densest cities with the most competitive entry, the Bell is still the only facilities-based option available in the vast majority of buildings. For example, in New York city, which is unquestionably the most competitive market in the nation, Verizon is the only facilities-based option to *85.9%* of the buildings AT&T serves.[27] The same is true in such cities as Los Angeles (95.4%), Chicago (94.0%), and Boston (86.5%).[28]

These figures are consistent with those provided by the other commenters. Despite an aggressive program to purchase special access from competitive carriers, "non-ILEC vendors have accounted for only approximately 10% of Cable & Wireless's new installations for the year 2002, *down* from approximately 13% in 2001."[29] "Sprint Long Distance . . . continues to rely upon the ILECs for approximately 93% of its total special access needs despite aggressive

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Declaration. *Compare* AT&T Petition, Thomas Decl. (stating that, as of March 2002, AT&T served approximately 6,000 buildings with its own facilities).

[26] *See* Selwyn Decl. ¶ 19 & Table 7. This is remarkably consistent across *all* MSAs. In MSAs where Bells have received Phase II relief for transport only, AT&T has no competitive alternative in 95.5% of the locations it serves. *Id.* And in MSAs where the Bells have no Phase II relief at all, AT&T has no competitive alternative in 97% of the locations it serves. *Id.*

[27] *See* Selwyn Decl. ¶ 20 & Table 8.

[28] *Id.*

[29] Cable & Wireless at 13.

attempts to self-supply and switch to CLEC-provided facilities wherever feasible."[30] In short, in the vast majority of buildings – which represent the substantial majority of overall access expenses – there is simply no alternative to the Bells.

In this regard, the Bells' oft-repeated citation to Mr. Dorman's statement that AT&T self-supplies 20% of its DS1 equivalents does not show that AT&T or any other special access customer generally has alternatives to the Bells. As an initial matter, it is hard to see how this figure helps the Bells as it shows that AT&T, which has perhaps the largest competitive network, is only able to build its own facilities to serve a small fraction of its overall access needs. Moreover, the 20 percent figure is overwhelmingly comprised of fiber optic facilities used to provide OCn level service. Because all high-capacity OCn services convert to a large number of DS1 equivalents, presenting data on the basis of DS1 equivalents will necessarily overstate the *scope* of competition. For example, the smallest OCn service, OC3, equates to 72 DS1 equivalents. Accordingly, if a CLEC self-deployed an OC3 to one building but leased 72 DS1s from the Bells to 72 separate buildings, looking at the data on a DS1 equivalent basis would show that the competitive carrier self-provided "50 percent" of its special access, when in reality it relies on the Bell for its special access connections to virtually all buildings.[31] And that is the case for AT&T. Although AT&T has generally been able to self-deploy facilities to the small number of buildings that generate enormous levels of demand and can justify a dedicated fiber facility, AT&T remains critically dependent upon the Bells for the lion's share of its special access needs, including virtually all of its DS1 purchases and the majority of its DS3 purchases.

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[30] Sprint at 3.

[31] In addition, estimates of CLEC DS1 equivalents tend to overstate the amount of actual services provided, because CLECs typically deploy higher capacity fiber facilities that are only partially filled. Indeed, a CLEC will often build a fiber loop even if will be only half filled.

Moreover, there can be no credible claim that new facilities-based alternatives are just over the horizon – particularly now that capital markets have effectively closed to competitive carriers. As AT&T has shown previously, the Bells enjoy enormous economies of scale and scope in the transport and loop facilities used to provide special access, and as a result the Bells have far lower costs per unit than the CLECs.[32] For these reasons, CLECs can economically build facilities to a building only when the building has very high demand.[33] And even when sufficient demand exists, CLECs are often unable to obtain the necessary rights-of-way in a reasonable time period or at reasonable costs.[34] As Professors Ordover and Willig explain, these economic realities mean that the Commission can expect very little bypass for the countless small and medium sized businesses that require connections at the DS3 level and below, which constitute the majority of the special access market both by locations and by Bell revenues.[35]

The Bells do not even attempt to controvert these hard data or the economic analysis showing why self-supply cannot be expected to serve other than the highest volume customers. Indeed, although the Bells know where they face competition and where they do not, they provide no statistics at all about the number of buildings in which they face facilities-based competition.

The Bells instead submit an unsworn "report" prepared by their lawyers that compiles meaningless national statistics taken from a hodgepodge of public sources. The Bells claim that their "fact" report establishes that competitive carriers have captured over 30% of special access

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[32] *See* AT&T Petition at 28-32; AT&T Triennial Review Reply Comments at 167-77, 244-57.

[33] Letter from Joan Marsh (AT&T) to Marlene Dortch (FCC), CC Docket No. 01-338, Attachment B (November 25, 2002).

[34] AT&T Triennial Review Reply Comments at 174-77.

[35] Ordover/Willig Reply Decl. ¶ 27.

revenues; that competitive carriers have deployed hundreds of thousands of miles of "local" fiber; and that a vibrant market for wholesale dark fiber has emerged.

These data – even if they had any basis in fact – are simply irrelevant. Highly aggregated national estimates of fiber and revenues are of no help at all in answering the relevant questions: To what extent do special access purchasers at each level (*e.g.*, DS1, DS3, OC3, etc.) actually have facilities-based alternatives to the Bells and whether that level of competition is enough to constrain the Bells' market power.[36] In particular, the Bells' data simply ignore the critical distinctions between OC-level facilities, for which meaningful competition exists on some routes and self-deployment can be an economic alternative, and DS-level facilities for which facilities-based alternatives rarely exist and cannot be economically deployed. This is critically important because DS-level transport constitutes the special access facilities needed to serve the vast majority of buildings.[37] In addition to aggregating all capabilities of special access circuits, the Bell data also hopelessly aggregates channel terminations and transport, a meaningless jumble that provide no information at all about the extent of actual *bypass* of the Bells' facilities. As Professor Ordover and Willig explain,

> The Commission's pricing flexibility rules deregulate both the Bells' transport *and* channel termination charges. Both inputs are necessary in order to provide special access to customers' premises. Even if there is competition in the provision of transport, to the extent that Bells control any bottleneck input necessary for special access, such as channel terminations, they can still earn monopoly rents on these bottleneck facilities. Thus, in assessing the existence of Bell market power, it is critical to determine whether carriers are able to obtain *all* of the last mile inputs necessary to provide finished services to end-user customers from alternatives other than the Bells.[38]

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[36] Ordover/Willig Decl. ¶¶ 19-22.

[37] *Id.* ¶¶ 29-30.

[38] *Id.* ¶ 22.

In all events, the Bells' "fact report" is riddled with errors. The "fact report" is trapped in a time warp. It springs from the "bubble" era where CLEC double-digit growth was presumed, where plans were accepted as fact, and where press releases and analyst statements were taken at face value. Of course, the bubble popped some time ago, nowhere more dramatically than for the CLEC sector under consideration, and the hype of 2000 cannot be taken as "evidence" in assessing today's competitive conditions.

Instead, CLECs' special access revenues are often in decline. Most large special access providers face the crippling uncertainties of bankruptcy. For all but a few competitors, capital markets barely support the funding needed for current operations, much less the expansive plans of another era.[39]

Bubble-era hype permeates the "fact report." For crucial evidence regarding CLEC network coverage, Verizon relies on announcements of "planned" or "intended" network rollout announced in 2000.[40] It cites Jack Grubman, the analyst who has come to symbolize the overstatement of the bubble era, to establish the robustness of the now-crippled "wholesale fiber"

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[39] For example, the fact report's claim that competitive carriers have over 30 percent of the special access market is based on gimmicks. The report relies on projections based on a "trend" derived from the NPRG analysis, but the most recent, 17th edition of the NPRG report (which the Bells ignore) anticipates much lower growth. Further, when verified Commission data are substituted for the fact report's speculations, the result is that competitive carriers account for only about 20 percent. And even this figure is grossly overstated for present purposes because that CLEC total is mostly revenues derived from *resold* Bell special access services. *See* Selwyn Decl. ¶ 38-42.

[40] Even the fact report's estimates of existing local fiber are wildly inflated. For example, Verizon claims that competitive carriers operate 184,000 route miles of fiber, the majority of which is local, but Verizon never explains how this figure was derived other than to say it is based on "public reports." In fact, most competitive carriers do not publicly state how much of their fiber is local (as Verizon concedes), and those that do make clear that the minority of their fiber deployment is local. For example, McLeodUSA, XO and Adelphia – which operate three of the largest competitive carrier networks – have deployed nearly 70,000 route miles of fiber, but only 19,000 miles – or 27 percent – are claimed to be "local." *See* Selwyn Decl. ¶ 50-51.

sector, with its promises of "an avalanche of metro capacity being deployed" but, alas, few services or revenues.[41] It credits as meaningful the announcement of a single "40.8 *million* round of equity financing," as though proof that the capital markets have not completely closed for CLECs in this sector could support the conclusion that facilities investment and special access competition are booming.[42] It cites a "web-based trading pit for metropolitan fiber" for its assertions regarding the robustness and scope of fiber wholesalers – but that web-based service has discontinued its locator service and contains no postings for the sale of under-deployed fiber.[43] And throughout its analysis, it relies almost entirely on superceded publications from the New Paradigm Resources Group, an organization which, like the Monty Python shopkeeper trying to sell the dead parrot that is "just sleeping," views bankruptcy as just a normal business condition that has the advantage of reducing interest expenses. *See* NRPG ("Chapter 11 Bankruptcy: A Hindrance or a Benefit?").

In short, the relevant question is the one the Commission posed in the *Pricing Flexibility Order* – *i.e.*, whether "*almost all* special access customers have a competitive alternative."[44] The Commission predicted that, under certain circumstances embodied in the collocation "triggers," such alternatives would exist. There is now overwhelming and uncontraverted evidence that this

[41] Of the nine companies Verizon cites as wholesale local fiber suppliers, three have filed for Chapter 11 bankruptcy, and several others are struggling. Others so far have deployed dark fiber in only a handful of smaller markets. Forecasts for the future are equally dim, and analysts now expect industry revenues to continue their recent decline for at least for the next two years. For these reasons, both analysts – and, elsewhere, witnesses for the Bells' themselves – have questioned whether the wholesale dark fiber market is even a *potentially* viable market. *See* Selwyn Decl. ¶¶ 52-57.

[42] *See* Selwyn Decl. ¶ 33.

[43] *Id*.

[44] *Pricing Flexibility Order* ¶ 104.

prediction was wrong. And without alternatives, IXCs, CMRS providers and other carriers have no choice but to pay the Bells' now unregulated monopoly charges for special access services.

B. The Bells' Actual Marketplace Behavior Confirms Their Unconstrained Market Power And The Necessity Of More Stringent Rate Regulation.

Although the new evidence that mere collocation has not, in fact, signaled, and cannot be counted upon to produce, real facilities-based alternatives is reason enough to mandate immediate Commission rate regulation reforms, the Bells' own behavior starkly confirms that market forces and competitive pressures are not, as the Commission predicted, constraining the Bells' prices.

1. The Bells Have Not, As Promised And Predicted, Reduced Rates To Respond To Competition.

The relevant facts are not in dispute. Prior to the *Pricing Flexibility Order*, the Bells claimed that they needed substantial deregulation of special access rates in order to meet competition from CLECs. The Bells complained that CLECs were winning customers by offering lower rates for special access services, and that the Commission's price cap rules, which required geographically averaged rates, prevented the Bells from matching the CLECs' rates and responding to this competition. Indeed, the Bells told the D.C. Circuit that unless they were given the flexibility to "*reduce* their rates in lower-cost areas and offer the *same* volume and term discounts as their competitors," they would suffer "truly irreparable losses" in the form of business lost to competitors.[45] The Bells told the Court that, without such pricing flexibility, "the public" would be deprived of the "benefits of more vigorous competition."[46]

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[45] *MCI WorldCom Inc.* v. *FCC*, Nos. 99-1395 *et al.*, Brief of Intervenors BellSouth, SBC, Verizon, and Qwest in Support of FCC, at 11 (filed August 4, 2000) (emphasis added).

[46] *Id*.

The Commission accepted these Bell representations. When it adopted the *Pricing Flexibility Order*, the Commission explained its belief that requiring the Bells to charge geographically averaged rates throughout a study area "forced [them] to price *above cost* in the high-traffic, lower-cost areas where competition is more likely to develop."[47] The Commission expressed its concern that such restrictions created a "pricing umbrella for competitors."[48] Based on those assumptions, the Commission gave the Bells what they wanted: upon the satisfaction of certain "triggers," the Commission would eliminate price cap regulation and give the Bells unfettered ability to enter into contract tariffs and to offer term and volume discounts. In taking these steps, the Commission expressly stated its expectation that the Bells would use that pricing freedom to *reduce* special access rates in lower-cost areas, to match the lower rates charged by CLECs.[49] Indeed, this was the principal purpose, and the central prediction, underlying the entire *Pricing Flexibility Order* – that regulatory freedom would allow the Bells to lower their rates as a response to competition.

The Commission now has more than two years of experience with pricing flexibility, and the Bells' claims have been exposed as a fraud. The indisputable fact is that the Bells have *not used pricing flexibility to meet competition*. The Bells have not lowered their rates in lower cost areas (or anywhere), nor have they matched the lower rates offered by CLECs. Rather, pricing flexibility has allowed the Bells to avoid the hundreds of millions of dollars of X-Factor

[47] *Pricing Flexibility Order* ¶ 20 (emphasis added).

[48] *Id.* ¶ 60. In that regard, Verizon's assertion (at 31) that special access rate reductions may harm facilities-based competitors such as Time Warner Telecom is meritless, especially considering that the entire point of the *Pricing Flexibility Order* was to permit the Bells to collapse the price umbrella and match the rates of those very providers. Perpetuation of the pricing flexibility regime therefore cannot be justified on the grounds that it has *failed* to achieve that goal.

[49] *E.g., Pricing Flexibility Order* ¶ 154.

reductions that would otherwise have applied – with the anomalous result that rates in Phase II pricing flexibility areas are now *higher* than rates in price capped areas – and it has allowed BellSouth, Verizon, and Qwest to *raise* rates in every MSA in which they have received Phase II relief.[50]

None of the competitive responses the Commission expected have materialized. The *Pricing Flexibility Order* has permitted the Bells to exercise unfettered monopoly power especially with respect to DS1 and DS3 services. This is one of the most striking flaws of current rate regulation – all special access services in Phase II areas are rate deregulated, even though the competitive alternatives that exist are overwhelmingly concentrated in the small minority of buildings served by OCn facilities.[51]

The Bells have quickly taken advantage of this flaw in the regime. Shortly after receiving Phase II pricing flexibility, BellSouth and Verizon increased their rates for DS1 service throughout every Phase II MSA in their regions, even in the central business districts of large cities such as New York, Boston, and Atlanta.[52] Two weeks after AT&T filed its Petition, Qwest also raised its rates for DS1 service in every Phase II MSA in its region.[53] BellSouth has also raised monthly rates for DS3 services in all of its Phase II MSAs throughout its region. The

[50] *See* Stith Reply Decl., Attachment.

[51] *See, e.g.*, WorldCom at 9 ("[i]t is not economically viable for CLECs to extend their fiber networks to any of the hundreds of thousands of buildings that require only a single DS3 or a handful of DS1s. Phase II relief is overbroad because it allows the ILECs to escape price cap regulation for *all* channel termination services, even the lower capacity DS1 and DS3 circuits for which CLEC alternatives do not exist today and are unlikely to exist in the future").

[52] As one example, BellSouth filed Transmittal No. 608, effective November 1, 2001, increasing Special Access rates for DS3 and DS1 services in MSAs with Phase II pricing flexibility.

[53] Qwest Transmittal No. 145 (filed October 31, 2002).

Bells are able to raise their rates for these services without fear of losing business, because there simply are no alternatives to these lower end Bell special access services.

DS1 and DS3 services represent the bulk of the special access market. As noted above, the vast majority of the buildings served by special access are served by either DS1 or DS3 services; only a small percentage of commercial buildings generate enough traffic to support services at the OCn level. As a result, the bulk of the Bells' special access revenues come from DS1 and DS3 services.[54] Indeed, 65% of AT&T's dedicated access expense is for DS1 and DS3 services. The fact that the Bells' Phase II rates (both OPP and month-to-month) are higher than their price capped rates is especially anomalous, because the Bells obviously have *lower* costs in the larger, denser cities where they have received pricing flexibility than they do in the smaller and less densely populated areas where their rates are still governed by price caps. Pricing flexibility has resulted in the Bells charging higher rates in the areas where they have lower costs – the exact opposite of what one would expect in a competitive market.

The Bells also have taken quick advantage of the Commission's decision to deregulate channel termination rates even though competitors rarely can deploy alternative channel termination facilities. Verizon, for example, has increased its prices for channel terminations in Phase II pricing areas virtually across-the-board.[55] As demonstrated in the attached declaration of Mr. Selwyn (¶ 10, Table 4), the channel termination portion of the total price for a single 10-mile two-ended DS-3 access circuit increased by 36%, while the transport component remained

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[54] Although the Bells do not report revenues by service in ARMIS, their TRP filings provide a breakdown of price-capped revenues for various categories of services. For example, SBC Ameritech's most recent TRP shows that, out of a total $601.9 million in special access revenues, DS1 services account for $363 million, as compared with $122.9 million for the DS3 category (which would for reporting purposes include all DS3 as well as OCn services).

[55] *See* Selwyn Decl. ¶ 10.

unchanged. For DS-1 circuits, Verizon increased channel terminations in some Phase II areas by as much as 24%, while increasing transport by only 4%.[56]

Such rate increases have resulted in stark differences between Phase II areas and price-capped areas. For example, while Verizon South's DS3 entrance facility rates in Phase II areas are 13% higher than those in price-capped areas, Verizon South's DS3 channel termination rates in Phase II areas are *71%* higher than in price capped areas (ranging from $1,210 to $1,331 higher).[57] Indeed, Verizon South's DS3 channel termination rates in density zone 1 of the most competitive MSAs in its region are $2,911.37, as compared with $1,700.96 in price-capped areas.[58] These rate differences can be explained only by the exercise of monopoly power.

Even where the Bells do face some competition – *i.e.*, for OCn services – they have not reduced rates to meet competition. To the contrary, rates for OCn services in Phase II MSAs are generally the same as, and in some instances greater than, the rates for the same services in price capped areas.[59] More importantly, however, CLECs' rates for OCn services remain far lower than the Bells' OCn rates in virtually all instances. Thus, even in this context, the Bells have made no attempt to meet competition with price reductions.[60]

Although the Bells' principal argument for pricing flexibility was the need to be able to lower prices to customers that were beginning to enjoy competitive alternatives, the Bells have made virtually no attempt to meet such competition by entering into individualized contract tariffs. For example, BellSouth admits (at 11) that it has entered into contract tariffs in its region

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[56] *Id.*

[57] *See* Selwyn ¶¶ 9-10 & Table 3.

[58] *See id*

[59] Stith Reply Decl., Attachment.

[60] Ordover/Willig Reply Decl. ¶ 37.

that provide discounts of only $9.5 million in *total*. Similarly, Verizon has established only two contract tariffs in its entire region, and the discounts provided in those tariffs do not even compensate for the rate increases it has imposed since receiving Phase II relief.[61] Qwest has no contract tariffs, and SBC's contract tariff activity has been negligible.[62] Moreover, many of the Bells' contract tariffs are limited geographically, and as a result there are numerous Phase II MSAs in which there is no contract tariff offering at all.[63] The Bells have barely attempted to reduce their rates even by these means that they claimed as the *raison d'etre* of pricing flexibility. And the Bells rebuff all attempts to negotiate any other arrangement.[64]

The only "competitive response" identified by the Bells is the availability of OPP tariffs. In fact, however, those contracts of adhesion (which were authorized and existed *before* pricing flexibility) only provide further proof of the Bells' enduring market power. As AT&T demonstrated, the Bells have raised or maintained their OPP rates just as they have their month-to-month rates; they have not reduced those rates to match CLEC offers. And the Bells' OPP

[61] Selwyn Decl. ¶¶ 12-13. Both of these contracts are with AT&T, the largest special access purchaser, but it appears that no other carrier has been able to negotiate any such arrangement with Verizon.

[62] Although SBC has entered into ten contract tariffs, six of them are limited to term plans for multiplexed DS0 interoffice transport to DS1, with no price concession for any other service. *See* Selwyn Decl. ¶ 14.

[63] *See id.* ¶ 15 & Table 5.

[64] *See, e.g.,* PaeTec at 4 ("PaeTec, despite frequent requests to the ILECs, has been unable to benefit by any 'flexibility' ILECs are authorized to exercise in order to meet challenges by asserted competitive special access providers"); AT&T Wireless at 6 ("AWS has been unsuccessful in getting any of the BOCs to engage in serious contract negotiations in areas where the BOC has obtained pricing flexibility"); Cable & Wireless at 15 ("[t]he BOCs, by contrast, have generally refused to negotiate better deals with Cable & Wireless, despite persistent efforts by Cable & Wireless"); Arch Wireless at 4; XO at 5.

rates in Phase II areas are now almost always higher than OPP rates in non-Phase II areas, as well as higher than CLEC rates.[65]

The Bells offer their special access customers two options, and two options only: they can either pay grossly exorbitant month-to-month rates, or, if they qualify for the OPP plan, they can obtain modest discounts that yield rates that are still far above CLEC rates. The OPP plans, however, impose costs beyond their basic charge. The Bells' OPPs require carriers to commit to use the Bells for up to five years, and, in some cases, require that the Bell be the *exclusive* (or near exclusive) special access provider for the carrier. As Professors Ordover and Willig explain, such terms entrench the Bells' dominance by making it difficult for competitive carriers to gain the customer base that they need to deploy alternative facilities.[66] Thus, to the extent there has been increased use of OPPs by IXCs and other carriers, this is not because the Bells' OPPs are competitively priced. Rather, the only way for carriers to mitigate the excessive month-to-month rates charged by the Bells is to purchase special access out of the OPPs.[67]

In short, there is no dispute that rates in every Phase II area for every service are now almost always higher than they would have been under price caps. This is all the more troubling because, as detailed below, these increases have occurred at a time when costs are rapidly decreasing.

Although the Bells' recent pricing behavior is perhaps the starkest confirmation of Bell market power, the comments show that the Bells have manifested that power in myriad other ways as well. Whereas CLECs have been willing to commit to performance guarantees, the

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[65] *See* Stith Reply Decl, Attachment.

[66] Ordover/Willig Reply Decl. ¶¶ 60-65.

[67] *Id.* ¶ 62.

Bells have steadfastly refused even to negotiate on this subject.[68] The result has been a decline in the overall performance by the Bells, even as they have *raised* rates.[69] In a competitive market, of course, a company cannot prosper while simultaneously increasing prices and decreasing quality.

Equally telling was the Bells' recent attempt to demand hundreds of millions of dollars of security deposits without regard to customers' ability to pay. This attempt to boost already bloated returns was foiled only by Commission intervention. The Commission found that the Bells' proposed tariffs were "not narrowly tailored to meet the incumbent LECs' need for additional protection against nonpayment without imposing undue burdens on access customers in general."[70] Again, given that CLECs were not seeking to impose these onerous terms, if there were broad-based bypass of incumbent facilities, as the Bells claim, the Bells would not even have attempted such a gambit.

2. The Bells' Attempts To Explain Away Their Rate Increases Are Patently Meritless.

The Bells' attempts to cloak their price increases in pro-competitive terms range from the meritless to the ludicrous. The Bells' principal defense is Kahn and Taylor's claim that special access revenue per line has actually declined on average between 1996 and 2001, on a DS0

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[68] *See Performance Measures and Standards for Interstate Special Access Services*, CC Docket No. 01-321, Notice of Proposed Rulemaking (rel. Nov. 19, 2001); *id.*, Comments of AT&T, filed January 22, 2002.

[69] Although Kahn and Taylor claim that the Bells' performance has been improving, the true picture is less sanguine. Kahn and Taylor's conclusion is based on trouble reports per voice grade equivalent line; when performance is measured based on trouble reports per order, the Bells' performance is much more varied, and indeed, when one removes Ameritech, average performance has been steadily *declining* during the period 1998-2001. *See* Selwyn Decl. ¶ 79.

[70] *Verizon Petition for Emergency Declaratory and Other Relief*, WC Docket No. 02-202, Policy Statement ¶ 6 (released December 23, 2002).

equivalent basis.[71] But Kahn and Taylor's own data actually tell a quite different story. Revenue per line did decline by an insignificant amount between 1997 and 2000 (although it actually increased from 1996 to 1997), but these declines should not be surprising, because at that time, the Bells were still governed by price caps and an X-Factor. Kahn and Taylor's own data, however, show that the Bells' revenue per line *increased* from 2000 to 2001, which happens to be the first year that any of the Bells received pricing flexibility.[72] Kahn and Taylor hide this inconvenient fact by burying it in a meaningless five-year average.[73]

Equally important, Kahn and Taylor focus on revenue per line on a DS0 equivalent basis and ignore its relationship to average "investment" and average "expense" per line during the same period. Although the Bells' revenue per DS0 equivalent line declined by 0.2% over the five-year period, average expense per DS0 equivalent line dropped by 48.5% and average investment per DS0 equivalent line dropped by 40.2%.[74] Accordingly, the Bells' net return, calculated on a DS0 equivalent basis, increased by *176%* from 1996 to 2001.[75]

In all events, calculating revenue per line on a DS0 equivalent basis is fundamentally misleading, because it ignores the fact that the Bells' effective price per DS0 equivalent circuit varies between different kinds of services.[76] In other words, the decline in revenue per DS0 equivalent line from 1996 to 2000 is likely due principally to a changing mix of services. Specifically, the Bells' higher capacity services – *i.e.*, DS3 and OCn services – likely grew at a

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[71] Kahn/Taylor Decl. at 15-16; SBC at 23-24.

[72] *See* Kahn/Taylor Decl. at 16 (chart).

[73] *See* Selwyn Decl. ¶ 76.

[74] *See id.* ¶ 77.

[75] *See id*.

[76] *See id.* ¶ 78.

faster rate over this period, and because the Bells' effective price per DS0 equivalent is lower for these services, this changing mix of services would manifest itself as a declining revenue per line when calculated on a DS0 equivalent basis. The more appropriate comparison, however, is to compare rates for the same service, and as AT&T has demonstrated, the Bells' Phase II rates are uniformly higher than their non-Phase II rates.

Likewise, while the Bells' revenues have increased, their costs have unquestionably decreased over the same period. For example, as Kahn and Taylor concede (at 12), demand for the Bells' special access services has increased markedly over the last several years. The Bells' networks are characterized by substantial economies of scale (as Kahn and Taylor also concede), and therefore the Bells' per-unit cost to provide special access has declined steeply, as their ARMIS submissions confirm.[77] Moreover, advances in fiber optic technology in recent years have also reduced the Bells' costs.[78] Again, in competitive markets, a decline in costs should lead to *lower* prices.[79]

Kahn and Taylor's economic rationale for the Bells' price increases is equally backwards. On the one hand, Kahn and Taylor assert that special access services exhibit declining marginal costs and substantial scale economies, a point on which all agree.[80] But then Kahn and Taylor argue that there has been an increase in overall demand for special access services – *i.e.*, in economic terms, that there has been an outward shift in the demand curve.[81] But if special access is characterized by scale economies, the supply curve would be downward sloping.

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[77] *See* Selwyn Decl. ¶ 77.

[78] *See, e.g.*, WorldCom at 4.

[79] Ordover/Willig Reply Decl. ¶ 91.

[80] *See* Kahn/Taylor Decl. at 14.

[81] *See Id.*, at 13-14.

Therefore, an increase in demand would result in a *lower* equilibrium price, not a higher one, as Kahn and Taylor claim. Thus, Kahn and Taylor's analysis simply confirms that the Bells in fact have market power and have used that market power to increase prices.[82]

The Bells also cite – but take out of context – the Commission's statement in the *Pricing Flexibility Order* that "some access rate increases may be warranted, because our rules may have required incumbent LECs to price access services below cost in certain areas."[83] The Commission may have accepted the possibility that there might be rate increases as part of a broader rebalancing of rates within an MSA,[84] but the *Pricing Flexibility Order* cannot remotely be read as endorsing *MSA-wide* rate increases of the sort the Bells have uniformly imposed on access purchasers since receiving Phase II removal of price caps.[85]

Verizon, in a desperate attempt to point to *some* competitive response on its part, cites to provisions in its pricing plans that offer protections against rate *increases* of more than 8%.[86] According to Verizon, "[i]f the market were non-competitive, as AT&T alleges, Verizon would have no need to be *so responsive*."[87] As a "competitive response" this is laughable, given that CLECs' rates are already substantially lower than Verizon's.

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[82] *See* Ordover/Willig Reply Decl. ¶ 41.

[83] *See Pricing Flexibility Order* ¶ 155; *see also, e.g.,* Verizon at 25.

[84] *See Pricing Flexibility Order* ¶¶ 154-55.

[85] *See also* FCC News Release, August 5, 1999 (announcing issuance of the *Pricing Flexibility Order* and stating that "[t]hese reforms will enable those companies to compete more efficiently, and customers of interstate access service should benefit from increased choices among carriers and *lower overall* rates" (emphasis added)).

[86] Verizon at 24 ("Verizon also protects all of its customers from large annual rate increases by enabling them to cancel their term plans if Verizon initiates a rate increase of 8 percent or more").

[87] *See id.* (emphasis added).

Verizon also suggests that its special access rates were "artificially depressed" at the time it received pricing flexibility, and that the elimination of rate regulation has permitted Verizon to "rationalize" its rate structure.[88] This is preposterous for at least two reasons. First, as shown above, Verizon has raised or maintained *all* of its rates; all of Verizon's rate "rationalization" has been upward.[89] Second, CLEC prices in Verizon's Phase II service areas are lower than Verizon's and have stayed lower even after Verizon's rate increases. Thus, whatever Verizon means when it says that its special access rates were "artificially depressed," it cannot be the case that regulation was holding Verizon's rates below *competitive* levels.

Qwest offers yet another theory: it says that its price increases are consistent with pricing generally in the telecommunications industry, in that "oversupply" initially caused unrealistic price decreases, but that the shakeout in the industry is now allowing prices to return to realistic levels.[90] In fact, the special access market is notable for its *dearth* of alternative last mile capacity, not oversupply – and certainly not a glut of capacity at the time the *Pricing Flexibility Order* was issued. Indeed, the Bells themselves concede that CLECs have built their own facilities to only a small fraction of the commercial buildings served by special access, and the

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[88] *See* Verizon at 25 & n.58.

[89] Verizon asserts in a footnote (at 25 n.58) that it has "reduced some rates and increased others," but it does not identify any Phase II rates that it has reduced. *See* Selwyn Decl. ¶ 6 ("[w]hile it is within the realm of possibility that prices for some elements of Verizon's Phase II areas did decline, our review of the tariffs failed to reveal any such instance"). Verizon also asserts (at 25 n.58) that it has "sought to expand the differential among zones 1, 2, and 3," but in fact Verizon has increased rates even in zone 1, and as a result, the difference in rates between the zones has remained the same while rate levels have increased. *See* Selwyn Decl. ¶ 7 & Table 1 ("Verizon has applied straight, across the board increases to the pricing flexibility price ranges for all three zones"). Verizon also suggests that its rate increases were necessary to "align" its special access rates between Verizon North and South, but in fact Verizon's price increases have resulted in a greater gap between rates in the Phase II areas of Verizon North and South than elsewhere. *See* Selwyn Decl. ¶ 8 & Table 2.

[90] Qwest at 26-27.

Bells' own evidence submitted in pricing flexibility petitions demonstrates that there are many wire centers in pricing flexibility MSAs that have no collocated competitors. On the vast majority of special access routes, the Bell is the *only* facilities-based provider. The real explanation for Qwest's pricing is much simpler: as explained above, Qwest has not reduced its rates to meet competition from CLECs; rather, as soon as it obtained Phase II relief, Qwest raised rates.[91]

There is only one explanation for the Bells' pricing behavior: they continue to have and exercise overwhelming market power in the special access market. The Commission predicted that pricing flexibility would lead the Bells to lower their rates in response to competitive entry. The prediction has not been borne out. The only consequence of pricing flexibility has been that the Bells have been able to avoid X-Factor reductions that would otherwise have applied and to impose additional rate increases. The facts unequivocally show that the competitive entry that exists is too limited to impose any meaningful competitive pressure on the Bells' rates.

C. The Bells' Enormous And Growing Special Access Profits Further Confirm That The Bells' Special Access Rates Are Unlawful.

The Bells do not dispute that sustained supracompetitive returns are powerful evidence of market power abuse. It is firmly established in both economics and law that effective competition drives prices toward cost; that participants in fully competitive markets can only expect to recover their costs, including their own costs of attracting capital; and that only firms with market power can expect consistently to earn profits that greatly exceed such economic profits.[92]

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[91] *See* Stith Reply Decl., Attachment.

[92] *See, e.g., Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, 11 FCC Rcd. 15499, ¶ 700 (1996) ("*Local Competition Order*")
(continued. . .)

Indeed, both the Commission and the courts have long recognized not only that returns that greatly exceed reasonable costs of capital signal a need for (or failure of) rate regulation, but that the Commission has a statutory obligation to eliminate such "creamy returns" with whatever regulations are needed to protect consumers from the unjust and unreasonable rates that have produced them. The Supreme Court and lower courts have consistently held that where "returns have greatly exceeded a fair percentage of return upon a fair base, it follows *as a matter of law* that the rates charged . . . , instead of being 'just and reasonable' . . . [are] excessive."[93] Similarly, the Commission has held that allowing "greater than a normal profit would not be 'reasonable.'"[94]

The Bells' suggest that the switch to price cap regulation has somehow severed the link between excessive returns and the need for rate regulation, but that is clearly wrong. To be sure, under the price cap mechanism, rates are not directly determined from the rate base and an authorized rate-of-return. But that does not mean that the Bells' excessive rates-of-return are irrelevant to whether there is a need for regulation. On the contrary, as the Commission has made clear since the outset of price-cap regulation, observed returns remain the primary tool for determining whether the specific price-cap rules are working to protect consumers from unjust and unreasonable rates or whether additional fine-tuning is required. Indeed, when the

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("normal profit is embodied in forward-looking costs because the forward-looking cost of capital, *i.e.,* the cost of obtaining debt and equity financing, is one of the forward-looking costs of providing the network elements"); Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission (issued 1992, revised 1997) ("Market power to a seller is the ability profitably to maintain prices above competitive levels for a significant period of time").

[93] *Potomac Elec. Power Co.* v. *Public Utils. Comm'n of the District of Columbia*, 158 F.2d 521, 523 (D.C. Cir. 1947) (quoting *Dayton-Goose Creek Co.* v. *United States*, 263 U.S. 456, 483 (1924)) (emphasis added).

[94] *Local Competition Order* ¶ 700; *see also, e.g., American Tel. & Tel. Co.* v. *FCC*, 572 F.2d 17 (2nd Cir. 1978) (internal quotations omitted).

Commission initially adopted the price-cap mechanism in 1989 it emphasized that "an acceptable price cap approach cannot free carriers to earn excessive profits in light of their costs."[95] Accordingly, the Commission stressed that its price cap regime would include "ongoing monitoring" and that a future "comprehensive review" of the price cap mechanisms would "focus prominently on carrier costs and profits."[96]

Consistent with this duty, the Commission has in the past carried out its promise (and legal duty) to adjust the price-cap mechanism to ensure that access rates remained at "just and reasonable levels." In 1995, the Commission found that "the price cap LECs had experienced higher earnings on average under price caps than in earlier periods" and found that these consistently high returns confirmed that the Commission's price cap system was not adequately constraining the Bells' prices.[97] Again in the *CALLS Order,* recognizing that the then-current "traffic-sensitive rate structure provide[d] price cap LECs with more revenue when demand increases, regardless of whether costs have increased, resulting in higher earnings," the Commission "target[ed] reductions to [those] traffic sensitive services."[98] And, in the *Pricing Flexibility Order* (¶ 3), the Commission determined that the pricing flexibility regime would be lawful only to the extent that "price cap LECs do not increase rates to unreasonable levels for

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[95] *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873, ¶ 884 (1989) ("*AT&T Price Cap Order*").

[96] *AT&T Price Cap Order* ¶ 885.

[97] *Price Cap Performance Review for Local Exchange Carriers*, 10 FCC Rcd. 8961, ¶ 100 (1995), *aff'd Bell Atlantic Tel. Cos.* v. *FCC,* 79 F.3d 1195, 1202 (D.C. Cir. 1996) (upholding the order based in part on the fact that "[t]he Commission originally predicted that sharing would be rare, . . . [but i]n practice, however, sharing had become routine. By 1993, all seven of the Bell Operating Companies were in the sharing zone, leading the Commission to believe that the original X-factor had been too low").

customers that lack competitive alternatives." Thus, contrary to the Bells' claims, the Commission neither has, nor lawfully could, abandon the established rule that sustained supracompetitive returns indicate a failure in the price cap mechanism that must be addressed.

Recognizing that the Commission cannot sit on the sidelines and allow them to continue extracting supracompetitive profits, the Bells take pot shots at the particular return data submitted by AT&T and other commenters. Tellingly, however, the Bells make no attempt to quantify the effect of the supposed errors or to offer their own estimate of their returns. That is particularly revealing, because the Bells, of course, have full information about their own costs and revenues (and also frequently submit detailed cost model estimates of the economic costs of providing loops, transport and other special access analogs). The Bells' silence on this critical issue can mean only one thing – their own numbers confirm their exorbitant special access returns.

It is not surprising therefore that the Bells' specific attacks on the returns computed using regulatory accounts do not withstand scrutiny. The Bells and their economists focus their attacks on the Bells' own ARMIS submissions. The Bells first claim that returns based upon forward-looking economic costs are preferable to returns based on their actual expenditures.[99] But when the Bells' special access revenues are measured against forward-looking costs, the returns are even *higher* than under ARMIS measures. Thus, measuring returns using ARMIS data necessarily generates conservatively *low* estimates of economic returns.

AT&T demonstrated in its initial Petition that computing the Bells' returns based on economic costs shows that the Bells' special access rates are as much as 400% higher than the

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[98] *Access Charge Reform*, Sixth Report And Order, 5 FCC Rcd. 12962, ¶ 171 & n.376 (2000) ("*CALLS Order*").

Bells' special access costs.[100] And even if those TELRIC cost estimates are doubled (or even tripled) – bringing them in line with what the Bells themselves have proposed as reasonable estimates of forward-looking costs – those estimates are still below the costs based on the Bells' regulatory accounts.[101] Put simply, this is not a case where the Bells have been caught driving 57 mph in a 55 mph zone. The Bells' special access returns grossly exceed the cost of providing those services, regardless of the cost measure used to compute those returns.

In any event, the Bells are simply wrong in claiming that the ARMIS-based returns are not instructive for purposes of determining the need for additional rate regulation. The Commission relies upon ARMIS data – which is self-reported by the Bells – for myriad regulatory purposes, including to implement low-end adjustments to eligible price-cap carriers, to justify exogenous cost changes to the price-cap indices, and to compute universal service contributions and support.[102] Indeed, the Bells' consistently champion the use of the ARMIS data as an accurate measure of returns when such use is to their advantage.

The Bells contend that their ARMIS data overstate returns because those accounts contain certain revenue and cost mismatches. In fact, however, the alleged revenue/cost mismatches either do not exist, or have only a miniscule impact on the returns. BellSouth and

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[99] *See, e.g.,* Kahn/Taylor at 7-9.

[100] *See* AT&T Petition at 10 & Tab C (Stith Decl.).

[101] Forward-looking cost-based estimates that directly estimate special access costs are not subject to any of the Bells' baseless criticisms (discussed below) regarding supposed revenue and cost mismatches or jurisdictional misallocation.

[102] *See, e.g.,* Report and Order In CC Docket Nos. 00-199, 97-212, and 90-286; Further Notice of Proposed Rulemaking in CC Dockets Nos. 00-199, 99-301 and 80-286, *2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II; amendments to the Uniform System of Accounts for Interconnection; Jurisdictional Separations Reform and*
(continued. . .)

Qwest assert that computing special access rates of return based on their regulatory accounts overstates actual returns because special access accounts include all DSL revenues, but not all DSL costs.[103] The facts tell a different story. First of all, SBC's special access returns – which, as Kahn & Taylor concede, do not reflect any DSL revenues[104] and, therefore, cannot possibly be affected by any mismatch – are the highest among all of the Bells. As for the other Bells, even assuming *arguendo* that *all* DSL revenues are included in the Bells' special access regulatory accounts and that only a portion of DSL costs are reflected in those accounts, that mismatch could have only a very negligible impact on the Bells' special access returns. Indeed, removing all DSL revenues from the special access category (but leaving in whatever DSL costs may be present) reduces the Bells' combined special access returns by only about 3 percentage points (from 37% to 34%).[105] And that estimate substantially overstates the impact of any mismatch because, as noted, it does not remove any of the DSL costs that were allocated to special access services.[106] It is not surprising, therefore, that the Bells' have not provided any calculations showing the impact of this purported "mismatch" on the return estimates.

The Bells' also float the idea that their special access returns may be inflated by the Commission's jurisdictional separations rules. Again, the Bells' omit any calculations that might show the impact of this alleged mismatch. That is because, in reality, the Commission's jurisdictional separations rules have very little to do with the actual allocation of costs to the

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Referral to the Federal-State Joint Board; Local Competition Reporting, FCC No. 01-305, ¶¶ 11-12 (released November 5, 2001).

[103] *See* BellSouth at 6; Qwest at 12; Kahn & Taylor at 14-15.

[104] Kahn/Taylor Decl. at 14 n.28 ("SBC provides DSL service through a separate affiliate and does not book DSL revenue to its interstate special access accounts").

[105] *See* Selwyn Decl. ¶ 67.

[106] *Id.*

Bells' special access accounts. The Bells' have internal jurisdictional separations assignment mechanisms to assign investment *directly* to the special access category based on the actual use of that investment. The Bells' expenses are then assigned to the special access category in proportion to the amount of investment that was assigned to the special access category by the Bells' internal assignment mechanisms. Thus, if there are any cost misallocation, they are the result of the Bells' internal mechanisms, not the result of the Commission's jurisdictional separations rules. Moreover, recent data confirms that costs are not – as the Bells' contend – under-allocated to special access. Indeed, between 1996 and 2001, the Bells' special access investment more than doubled, whereas the Bells' intrastate investments actually *decreased* by $10 billion.[107] Thus, if anything, it appears that the Bells' are over-allocating costs to the special access accounts.[108]

The Bells' other theories – *e.g.,* that allocation of packet switching, marketing, or tertiary costs might create a cost revenue mismatch that overstates their returns – also lack merit. Again, the Bells' provide no evidence whatsoever that their returns are inflated by any of these purported cost/revenue mismatches. Revenues from packet switching generally would be recovered through switching tariffs and allocated to switching accounts, not special access.[109] Marketing expenses make up only a very small portion of revenues – indeed, even if *all* marketing costs were allocated to special access, that would make only a small dent in the Bells'

[107] *See* Selwyn Decl. ¶ 69.

[108] The Bells' complaints about the Commission's jurisdictional separations rules, even if valid, also would not explain the consistent sharp year-to-year increases in the Bells' special access returns. During the relevant time period, the Commission's jurisdictional separations rules have remained static and, therefore, could not have caused the substantial observed increases in the Bells' special access returns.

[109] *See* Selwyn Decl. ¶ 71.

returns.[110] Likewise, secondary and tertiary expenses make up only a very small portion of special access costs, thereby rendering any potential small mismatches insignificant.[111]

There is another serious problem with the Bells' arguments that the revenue/cost mismatches overstate their special access returns – the Bells' ignore other characteristics of the regulatory accounts that cause their regulated returns to be substantially *understated*. The Commission's 1999 audit reports of the Bells' continuing property records, for instance, found that the Bells could not account for approximately $5 billion in central office equipment that remained on the Bells' regulatory books.[112] If similar record-keeping practices exist with respect to special access investments, then the Bells' regulatory books include "phantom costs" that would understate special access returns.[113]

The bottom line is this: Under any reasonable measure, the Bells' special access returns so far exceed the returns that would be available in a competitive market that the only explanation is unconstrained market power that the Commission has an obligation to remedy.

II. THE COMMISSION HAS A LEGAL OBLIGATION TO ACT.

It is now crystal clear that the Commission's predictive judgments that special access rates would be disciplined by competitive entry were wrong. Facilities-based competition for all

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[110] *See id*. ¶ 70. The Bells' ARMIS submissions show that the Bells' total switched interstate marketing expenses were about $550 million dollars. Even if all of these other marketing expenses were allocated to special access – which is obviously wrong – those additional costs are very small relative to the Bells' more than $12 *billion* in revenues.

[111] *See id.* ¶ 72.

[112] *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers; Ameritech Corporation Telephone Operating Companies' Continuing Property Records Audit, et. al., GTE Telephone Operating Companies Release of Information Obtained During Joint Audit*, CC Dockets 98-137 and 99-117, AAD File No. 98-26, FCC 00-119, ¶ 15 (released April 3, 2000).

[113] *See* Selwyn Decl. ¶ 74.

but the highest capacity special access facilities remains extremely limited. Yet the Commission's pricing flexibility rules have allowed the Bells to avoid rate regulation for all capacities and to all locations within entire MSAs. As a result, the Bells' ability to exercise market power is now limited by neither competition nor appropriate federal regulation. And the Bells plainly have taken advantage of that void by implementing supracompetitive prices. The Communications Act's most basic directive to the Commission – to ensure that Title II carriers' rates are just and reasonable[114] – is triggered. And the courts have made clear that, in such circumstances, Commission action is not merely warranted, but required.

The Bells do not dispute that the Commission is legally obligated to revisit decisions that were based on unrealized predictive judgments. It is black letter law that administrative agencies must, on their own initiative, keep close tabs on decisions that are based on predictive judgments, and where those predictions do not pan out, address any deficiencies that arise in the rules on which those predictive judgments were based. The fact that AT&T and other carriers have now conclusively demonstrated that the Commission's unrealized predictions have permitted the Bells to charge unlawful rates only heightens the Commission's obligation to act and to act quickly.

An agency has a bedrock obligation to ensure that current facts support its ongoing policy.[115] And "it is settled law that an agency may be forced to reexamine its approach if a

[114] 47 U.S.C. § 201(b).

[115] *See, e.g., National Broadcasting Co.* v. *United States*, 319 U.S. 190, 225 (1943) ("If time and changing circumstances reveal that the 'public interest' is not served by application of the Regulations, it must be assumed that the Commission will act in accordance with its statutory obligations").

significant factual predicate of its prior decision . . . has been removed."[116] In light of these precedents, the Commission has repeatedly acknowledged that it is obliged to revisit a prior rule when presented with facts that indicate that the original policy does not operate as the Commission had assumed or predicted.[117]

But that duty is particularly heightened where, as here, the challenged policy determinations initially rested on predictions rather than a developed record.[118] In reviewing the Commission's "predictive judgment" regarding "effective competition" for cable television services, the D.C. Circuit stated that "where the Commission itself has recognized the tentative nature of its predictive judgments . . . we find it particularly appropriate to emphasize the need for the Commission to vigilantly monitor the consequences of its rate regulation rules."[119] "The Commission's necessarily wide latitude to make policy based on its predictive judgments deriving from its general expertise implies a correlative duty to evaluate its policies over time to ascertain whether they work – that is, whether they actually produce the benefits the Commission

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[116] *Bechtel* v. *FCC*, 957 F.2d 873, 881 (D.C. Cir. 1992) (internal quote omitted) (and cases cited).

[117] *See, e.g., Amendment of Section 73.3555*, Report and Order, 100 F.C.C.2d 17, ¶ 19 (1984); *Access Charge Reform; Price Cap Performance Review*, First Report and Order, 12 FCC Rcd. 15982, ¶ 93 (1997) ("*Access Charge Reform Order*").

[118] *See WorldCom* v. *FCC*, 238 F.3d 449, 459 (D.C. Cir. 2001) (deference afforded to an apparently reasonable prediction, and "[t]he FCC readily admits that its decision to adopt the thresholds contained in the *Pricing Flexibility Order* [is] dependent, at least in part, on the agency's predictive forecasts"); *Pricing Flexibility Order* ¶¶ 96, 103-04.

[119] *ACLU* v. *FCC*, 823 F.2d 1554, 1565 (D.C. Cir. 1987). *See also WWHT, Inc.* v. *FCC*, 656 F.2d 807, 819 (D.C. Cir. 1981) ("[A]n agency may be forced by a reviewing court to institute rulemaking proceedings if a significant factual predicate of a prior decision on the subject (either to promulgate or not to promulgate specific rules) has been removed.").

originally predicted they would."[120] The Commission itself has acknowledged this obligation.[121]

Indeed, the Commission has acknowledged this obligation in the specific context of price cap regulation. As noted, when it originally adopted price cap regulation, for example, the Commission expressly stated that "an acceptable price cap approach cannot free carriers to earn excessive profits in light of their costs."[122] To the contrary, the Commission indicated that it "stand[s] poised to make prospective adjustments to the PCI formula to ensure that consumers share in the [price cap carriers'] productivity improvements."[123]

These principles require the Commission immediately to initiate the rulemaking that AT&T seeks. As described above, the *Pricing Flexibility Order* did not find that alternative bypass facilities existed that were sufficient to constrain Bell market power; rather, it *predicted* that where there was a certain level of collocation in incumbent LEC central offices, that additional entry would occur and constrain any attempt by the Bells to exercise market power. The D.C. Circuit upheld the Commission's order due to the deference afforded such predictive judgments. Even apart from the showing by AT&T and others that the Bells do not face competitive pressure and have responded to deregulation by raising rates, the Commission has an independent obligation to ensure that its predictions were, in fact, accurate. *A fortiori*, presented with record evidence that confirms that its predictions have turned out to be false, the

[120] *Bechtel* v. *FCC*, 957 F.2d at 881 (internal citation omitted).

[121] *See, e.g., Reexamination of the Policy Statement on Competitive Broadcast Hearings*, Notice of Proposed Rulemaking, 7 FCC Rcd. 2664, ¶ 4 (1992); *Amendment of the Commission's Rules to Establish Part 27*, Report and Order, 12 FCC Rcd 3977, ¶ 27 (1997) (policy based on "realistic assumptions" which, if shown not to be accurate in practice, "we would of course revisit this issue and make appropriate adjustments").

[122] *AT&T Price Cap Order* ¶ 885

Commission can no longer rely on its earlier predictive judgment. It must instead revisit and recraft the rules governing the pricing of special access services in light of the evidence before the Commission, together with further evidence to be developed in the new rulemaking.

III. SPECIAL ACCESS ABUSES ARE CAUSING PROFOUND AND INCREASING HARM IN ALL COMMUNICATIONS MARKETS.

This is a proceeding that should receive the Commission's highest priority. Immediate action by the Commission is necessary because the Bells increasingly have the ability and incentive to use their special access dominance to harm consumers and competition in multiple markets. The Bells' supracompetitive prices in many cases are borne directly by end-user customers who have no competitive alternatives. In other cases, the Bells' supracompetitive prices are borne by Bell competitors (to the extent that those competitors are unable to pass on the excessive rates to end-user customers). In either case, the Bells' enormous profits come at the expense of medium- and small-sized business customers who require those services to conduct everyday business.

The Bells' supracompetive special access prices also threaten consumers and competition in other markets. As one example, the Bells are increasingly winning authority to offer interLATA services that rely on special access inputs. As a result, the Bells' excessive special access prices effectively raise their rivals' costs, which means that the Bells can, and are, leveraging their market power over special access services to gain a competitive advantage in these downstream markets.[124] Indeed, the Bells have long had authority to offer *intra*LATA

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[123] *Id*.

[124] *See generally Premier Elec. Constr. Co.* v. *National Elec. Contractors Ass'n*, 814 F.2d 358, 368 (7th Cir. 1987) (citing T. Krattenmaker & S. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 Yale L.J. 209 (1986)) (explaining the ability to (continued. . .)

Frame Relay and ATM services, and their special access bottleneck has allowed them to dominate those services with *more than a 90%* share.[125]

Special access is also a critical input for next generation broadband services.[126] Absent prompt Commission action, the Bells have the incentive and ability to price squeeze broadband providers to gain an anticompetitive advantage. Indeed, the Bells have recently announced plans aggressively to market "enterprise" services to multi-location business customers that currently buy (or potentially would buy) such services.[127] With their artificial cost advantage, the Bells will be able to price squeeze these broadband providers, which in turn would force these companies either to reduce their rates – possibly to a level that would make service unprofitable – or try to pass along to their customers the monopoly charges that they are paying for special access – at a cost of ceding market share to the Bells. Either way, the Bells will gain an advantage in broadband services not through superior service or efficiency, but simply because of their bottleneck monopolies. Allowing this to happen could not be reconciled with the Commission's stated commitment to stand "alert and ready to act against anticompetitive risks and discriminatory provisioning by dominant providers" that could threaten broadband competition.[128]

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obtain or preserve market power from raising rivals' costs); *see also Access Reform Order* ¶ 277.

[125] *See* IDC, *U.S. Packet/Cell-Based Services Market Forecast and Analysis*, 2000-2005, at 34, 69 (2001); *see also* Selwyn Decl. ¶¶ 59-71.

[126] *See* Cable & Wireless at 7-10.

[127] *See* http://newscenter.verizon.com/proactive/newsroom/release.vtml?id=77993.

[128] *Wireline Broadband Classification NPRM* ¶ 5.

The Bells' abuses with respect to special access services also harm wireless competition.[129] As the comments show, wireless companies require special access to transport traffic between cell stations and their switches.[130] In order to meet consumer demand, wireless companies are increasingly locating cell stations in the outer suburbs and rural areas. Further, wireless carriers usually require only DS-level transport.[131] But, there are generally *no* bypass facilities in these areas, let alone facilities that could efficiently provide DS-level transport.[132] Thus, like IXCs, wireless carriers depend on the Bells for the lion's share of their special access needs. This puts "independent" wireless carriers at an increasing competitive disadvantage against those wireless carriers that are owned and operated by the Bells.[133]

Finally, exorbitant special access prices threaten to entrench further the Bells' local dominance.[134] The Commission's existing use and co-mingling restrictions prevent CLECs from purchasing loop-transport combinations as unbundled network elements.[135] CLECs need access to Bell loop and transport facilities in order to reach customers that do not have sufficient traffic to justify deployment of bypass transmission facilities. Likewise, loop-transport combinations can serve as a "bridge" that allows a CLEC to overcome sunk cost entry barriers. Access to the Bell network permits a CLEC to gain a customer base first and then build facilities once it is clear that the CLEC has sufficient demand profitably to deploy those facilities. In this context,

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[129] *See* Arch Wireless at 3-4; AT&T Wireless at 2-3; *Ex Parte Letter* from Doug Bonner (T-Mobile) to Marlene Dortch, at 1 (Jan. 6, 2003) ("T-Mobile *Ex Parte*").

[130] *See, e.g.,* T-Mobile *Ex Parte* at 1.

[131] *Id.*; Arch Wireless at 3.

[132] T-Mobile *Ex Parte* at 2; AT&T Wireless at 2-3.

[133] Ordover/Willig Reply Decl. ¶¶ 70-72.

[134] *See id.* ¶¶ 73-74.

[135] AT&T Triennial Review Reply Comments at 283-96.

above cost special access rates put CLECs at a competitive disadvantage. CLECs that rely on Bell-provided special access will, by definition, have much higher costs than the Bells, which pay only the economic costs of access. Thus, by maintaining supracompetitive rates for special access, the Bells are able to deter entry that would undermine their dominance.[136]

Predictably, the Bells deny that they have any incentives to undertake such predation. First, they argue that their long distance and wireless services are provided through separate affiliates and that it would not be profitable for the affiliate to set a low price in order to price squeeze its rivals because "it entails the [Bell's long distance/wireless] affiliate sacrificing profits for some period of time."[137] This contention is contrary to basic economics. As Professors Ordover and Willig explain, "firms with separate subsidiaries engage in joint profit maximization – *i.e.*, they maximize overall profits, not the profits of particular corporate entities."[138] Thus, because a price squeeze can increase overall Bell profits, the fact that an affiliate's short term profits might be diminished is irrelevant.

In the alternative, the Bells fall back on their shopworn argument that they have no incentive to price squeeze rivals because they will not want to forego any short terms profits they earn by setting prices that reflect their anticompetitive cost advantage. In other words, the Bells argue that after raising their rivals' costs, rather than attempting to underprice their rivals, they would prefer to set their prices at the level that reflects the higher costs that their rivals incur due to having to pay the Bells' supracompetitive access charges. But the fact that the Bells may find it profit maximizing to set prices for competitors and customers that reflect monopoly rents is

[136] Ordover/Willig Reply Decl. ¶ 74.

[137] Kahn/Taylor Decl. at 35.

[138] Ordover/Willig Reply Decl. ¶ 66.

hardly a compelling reason for the Commission to remain on the sidelines.[139] It is precisely for this reason that the D.C. Circuit has held that price squeezes are contrary to the public interest even if the Bells do not "absolutely preclude" competition by setting a retail rate that is below the price that they are charging.[140] Given the extent of anticompetitive harms that the Bells' exorbitant special access rates are causing today in all communications markets, the Commission should act immediately to re-establish effective regulation of those rates.

IV. AT&T'S PROPOSED INTERIM RELIEF IS APPROPRIATE.

In the mere 100 days since AT&T filed its Petition, the Bells' excessive rates have produced revenues that exceed those that would produce a 11.25% return by more than one *billion* dollars. The need for renewed and effective regulation of the Bells' monopoly rates is urgent. The Commission should therefore provide interim relief immediately, while it promptly initiates a broader rulemaking proceeding to re-establish effective regulation of the Bells' special access charges.

The interim relief should take three forms. First, the Commission should immediately impose a moratorium on all new pricing flexibility petitions during the pendency of the rulemaking. Second, the Commission should immediately reduce all special access charges for services subject to Phase II pricing flexibility to rates that would produce a generous 11.25% rate of return, and it should make clear that any required price reductions will not trigger any termination or other penalties currently embodied in the Bells' OPPs. Third, the Commission

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[139] *Id.* ¶ 67.

[140] *WorldCom Inc.* v. *FCC*, 308 F.3d 1, 10 (D.C. Cir. 2002) (quoting *Anaheim* v. *FERC*, 941 F.2d 1234, 1238 (D.C. Cir. 1991)) (it is against the "public interest" for the Commission to permit any price squeeze that "exert[s] *any* anticompetitive effects," even if it does not "*absolutely* preclude" competition) (emphasis in original).

should immediately eliminate use and commingling restrictions on unbundled network elements, to give carriers the option of a cost-based alternative to the Bells' special access services.

The Bells' suggestion that the Commission is powerless to take any of these interim actions to protect consumers from unjust and unreasonable rates and practices is simply preposterous. Contrary to Verizon's suggestion, an agency has substantial latitude in setting rights and duties in the course of, and prior to, exercising its discretion as how best to establish policy.[141] A reviewing court is "particularly comfortable deferring to the Commission's judgment because the agency adopted [its order] only as a limited transitional plan to address public policy concerns."[142] Under these standards, the Commission has ample authority to provide the interim relief requested here.

Moratorium. First, there is no basis to Verizon's heated claims that the Commission is without power to impose a moratorium on the submission of additional pricing flexibility petitions.[143] Verizon seeks to distinguish the many cases that AT&T cited on their facts, but the cases consistently implement a general principle that applies here: An agency acts reasonably when it freezes the status quo "in order properly to determine where the public interest lies in light of recent changes in the … industry" or to "study and evaluate whether the programs actually were achieving – rather than frustrating – the purpose of the Congress in authorizing

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[141] *See, e.g., Neighborhood TV Co.* v. *FCC*, 742 F.2d 629, 645-50 (D.C. Cir. 1984); *Lincoln Tel. & Tel. Co.* v. *FCC*, 659 F.2d 1092, 1107-08 (D.C. Cir. 1981); *Kessler* v. *FCC*, 326 F.2d 673, 679-85 (D.C. Cir. 1963); *see also U.S.* v. *Southwestern Cable Co.*, 392 U.S. 157, 179-80 (1968) (FCC power to preserve a situation pending a determination in a broader proceeding).

[142] *AT&T* v. *FCC*, 220 F.3d 607, 631 (D.C. Cir. 2000) (internal quotation omitted); *see also Competitive Tel. Ass'n* v. *FCC*, 117 F.3d 1068, 1073-74 (8th Cir. 1997); *MCI Corp.* v. *FCC*, 750 F.2d 135, 140-41 (D.C. Cir. 1984); *Mid-Tex Electric Cooperative* v. *FERC*, 822 F.2d 1123, 1132 (D.C. Cir. 1987).

[143] Verizon at 34-38.

them" in the course of considering new rules.[144] Each of the cases that Verizon seeks to distinguish did not turn on particular facts but rather, as would be the case if the Commission initiated the rulemaking that AT&T seeks, reflected reasoned agency decisionmaking that sought to limit the adverse effects of a regulatory regime that appeared counterproductive and that the agency was revisiting.[145] The Commission's power was upheld not to avoid an "unscrambling the egg" problem, as Verizon would have it, but because the Commission has substantial discretion, and is obliged, to discontinue a practice that it believes may no longer serve the public interest, particularly in furtherance of its decisionmaking that will likely establish new policies.[146]

Interim Price Cap Modifications. Similarly, as AT&T explained in its Petition, the Commission should also, on an interim basis, immediately reduce all special access charges for services subject to Phase II pricing flexibility to rates that would produce an 11.25% rate of return. Contrary to Verizon's suggestion, this relief would not violate the procedural requirements of section 205, for several reasons.[147] First, it is well settled that the Commission can satisfy section 205's requirement for a hearing by conducting notice and comment

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[144] *Western Coal Traffic League* v. *Surface Transportation Board*, 216 F.3d 1168, 1173-74 (D.C. Cir. 2000).

[145] *See Neighborhood TV Co., Inc.*, 742 F.2d at 634-40; *Kessler*, 326 F.2d at 679-85; *Western Coal Traffic League*, 216 F.3d at 1177.

[146] *See generally United States* v. *Southwestern Cable Co.*, 392 U.S. 157 (1968) (47 U.S.C. § 154(i) provides FCC with broad power to freeze status quo pending policy determination); *see also Permian Basin Area Rate Cases*, 390 U.S. 747, 777-81 (1968) (moratorium on rate filings); *Krueger* v. *Morton*, 539 F.2d 235, 239-40 (D.C. Cir. 1976) ("pause" in issuing coal permits pending enactment of better system); *Commonwealth of Pennsylvania* v. *Lynn*, 501 F.2d 848 (D.C. Cir. 1974) (suspension of grants under program subject to review).

[147] 47 U.S.C. § 205, *see* Verizon at 34-35.

rulemaking procedures.[148] Indeed, the notice and comment proceedings that have *already* occurred in response to AT&T's Petition would fully satisfy the requirements of section 205, even assuming that the requested relief would constitute a rate prescription. The Bells have had "fair notice of, and full opportunity to comment on, the issues raised concerning the appropriate level of future rates" – which is all that Section 205 requires.[149]

In all events, the Commission has made clear that the imposition of price caps is not a rate prescription at all, but only a "safe harbor" of rates that is presumptively lawful.[150] And even if rates were fixed rather than subject to the price cap regime, no prescription would be involved, at least if interim changes were made subject to later adjustments in light of the Commission's final determinations in the rulemaking proceeding.[151] Instead, it is clear that the agency's general powers, noted above, also extend to interim arrangements that affect rates.[152]

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[148] *See, e.g., International Settlement Rates*, IB Docket No. 96-261, Report and Order, 12 FCC Rcd. 19806, ¶ 300 (1997) (noting that the Supreme Court has held that the notice and comment provisions of the APA (5 U.S.C. § 553) satisfy section 205's hearing requirement); *United States* v. *Florida East Coast Ry.*, 410 U.S. 224, 239 (1973); *AT&T* v. *FCC*, 572 F.2d 17, 22 (2d Cir. 1978).

[149] *AT&T Corp*. v. *Business Telecom Inc.*, 16 FCC Rcd. 12312, ¶ 15 (2001).

[150] *See e.g., Policy and Rules Concerning Rates for Dominant Carriers,* Report and Order, 4 FCC Rcd. 2873, ¶¶ 894-95 (1989).

[151] *See Lincoln Tel. & Tel.*, 659 F.2d at 1107 (labeling interim charges as a "prescription" is a "gross mischaracterization" when charges are subject to adjustment following final agency determination). If interim relief regarding rates includes a mechanism for an adjustment following the outcome of the requested rulemaking, the propriety of the Commission's action would be beyond doubt.

[152] *See id.* at 1107-08 (47 U.S.C. § 154(i) empowers the Commission to establish interim billing system); *FTC Communications* v. *FCC*, 750 F.2d 226, 232 (2d Cir. 1984) (upholding Commission's establishment of interim rates pursuant to 47 U.S.C. § 154(i)). Verizon's effort (at 35 n.78) to distinguish *Lincoln Tel. & Tel.* on the ground that it involved the establishment of initial rates is nonsense. Reinstating a formerly applicable price cap regime by revoking an inappropriately granted waiver from that regime is, if anything, a more modest use of power, and in any event the *Lincoln* court relied on the Commission's broad powers rather than on the nature of the rates imposed. *See Lincoln Tel. & Tel.*, 659 F.2d at 1107-08; *see also FTC*
(continued. . .)

The relief from termination liabilities that AT&T requests follows directly from the other elements of relief, because the Bells' customers should not be penalized due to a defect found or suspected in the pricing flexibility regime that has provided unjustified windfall benefits to the Bells. Verizon provides no evidence that the Commission is without authority to grant this relief; indeed, Verizon *concedes* (and cites several cases in support of) the proposition that the Commission has ample authority to abrogate termination liability penalties when such penalties have been used to "lock up" the market.[153] As AT&T and others have demonstrated, that is precisely what the Bells have done here: the Bells' minimum traffic commitments and other exclusivity provisions not only prevent access purchasers from diverting more than a small percentage of their traffic to competitive alternatives, but they in fact deter competitors from building alternatives in the first place, because competitors know that most traffic is "locked into" the Bells.[154] The Bells' termination liability penalties are simply another manifestation of their market power and should be abrogated along with their excessive rates.

Use Restrictions. Finally, perhaps the simplest form of relief would be to eliminate the use restrictions and ban on commingling that currently apply to pre-existing combinations of

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Communications v. *FCC*, 750 F.2d at 232 (upholding Commission imposition of interim rates that replaced expired contract rates between parties). *Compare United States* v. *Southwestern Cable Co.*, 392 U.S. 157 (1968) (47 U.S.C. § 154(i) supports Commission restriction "pending appropriate hearings"); *Trans Alaska Pipeline Rate Cases*, 436 U.S. 631 (1978) (approving agency's interim rate refund mechanism); *Mid-Tex Electric Cooperative, Inc.* v. *FERC*, 822 F.2d 1123 (D.C. Cir. 1987) (upholding interim rate structure imposed pending formal proceedings).

[153] *See* Verizon at 37-38.

[154] *See* LDMI at 8-9 ("[w]ith the customers effectively precluded from moving their traffic, there is no economic justification for other vendors . . . to invest in constructing competing networks"); *see also id.* at 8 ("the Commission should realize that facilities-based competition does not occur simply by [the passage of] legislation and announcements by government regulators that they favor it").

unbundled loops and transport (usually called enhanced extended links, or "EELs").[155] Access to EELs would give competitors the option of converting existing special access circuits to unbundled network elements, which are priced at cost-based rates. Indeed, although many state commissions have not established rates for higher capacity unbundled loops, most states have established such rates for DS1 loops, and as a result elimination of the use restrictions would allow competitors to obtain immediate relief in the portion of the special access market where the Bells have maximum monopoly power (*i.e.*, DS1 services).

Contrary to the Bells' claims, the D.C. Circuit's recent decision in *Competitive Telecommunications Ass'n* v. *FCC*, 309 F.3d 8 (2002) ("*CompTel*"), does not preclude elimination of the use restrictions. First and foremost, the Court stated merely that the statute *permits* the Commission to conduct the Section 251(d)(2) impairment inquiry on a service-by-service basis; it did not prejudge the results of any such inquiry.[156] As AT&T has shown in the *Triennial Review* proceeding, requesting carriers are in fact "impaired" in their ability to offer any telecommunications service without access to high capacity transport and loops, and therefore the Commission can and should return EELs to the national UNE list without restrictions.[157]

Moreover, both of the reasons the Commission previously gave for the "interim" use restrictions, which the D.C. Circuit credited in *CompTel*, now no longer support those restrictions. First, protecting the Bells' special access revenues is no longer necessary to protect

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[155] *See Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Supplemental Order, 15 FCC Rcd. 1760 (1999); *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Supplemental Order Clarification, 15 FCC Rcd. 9587 (2000).

[156] *See CompTel*, 309 F.3d at 12.

[157] *See generally* AT&T Triennial Review Comments and Reply Comments.

universal service (if it ever was). It is well-established that there are no universal service subsidies in special access.[158] Indeed, the only concern has been that, at the *margin*, some access customers might purchase EELs instead of switched access, resulting in a slight erosion of whatever subsidies are contained in switched access. As the D.C. Circuit acknowledged, however, the only such subsidies are those contained in two carrier charges (the PICC and CCLC), and only to the extent that those charges have not been converted to SLCs paid by end-users. As of today, however, the PICC and CCLC have been almost entirely eliminated, and therefore removal of the use restrictions would have no material impact on universal service.

Similarly, elimination of use restrictions would not undercut the position of facilities-based competitors. First, neither the Commission nor the D.C. Circuit has ever found that elimination of use restrictions would undermine facilities-based competitors, only that it might and that the question deserved study.[159] The evidence submitted in the Triennial Review proceeding demonstrates that carriers are impaired in their ability to offer service *without* access to these UNEs, and that access to UNEs actually helps facilities-based access providers, because it allows such carriers to bring more traffic to points of aggregation more cost-effectively, thus justifying *more* facilities construction, not less.

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[158] *See, e.g., Access Reform Order* ¶ 404 ("established" practice is that "special access will not subsidize other services").

[159] *See CompTel*, 309 F.3d at 24-26.

CONCLUSION

For the foregoing reasons, and for the reasons in AT&T's Petition, the Commission (1) should initiate a rulemaking to reform and tighten rate regulation of the price cap ILECs' special access services, (2) impose a moratorium on consideration of further pricing flexibility applications pending completion of this rulemaking, and (3) on an interim basis, immediately reduce all special access charges for services currently subject to Phase II pricing flexibility to levels that would produce an 11.25% rate of return, make clear that any such rate reductions will not trigger any termination or other liability penalties, and eliminate use and commingling restrictions on EELs.

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January 23, 2003

CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of January, 2003, I caused true and correct copies of the forgoing Reply Comments of AT&T Corp. to be served on all parties by mailing, postage prepaid to their addresses listed on the attached service list.

Dated: January 23, 2003
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/s/ Peter M. Andros

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